It Is Hard To Say Goodbye

by Steve Brown

Science tells us that decay is the process by which organic substances break down and decompose. All organic material is constantly decomposing, but the environment where the plant or animal is located makes a big difference in the speed of decay. The invasion of microbes, whether attacking the ripe peach sitting on the kitchen counter or the potato salad in the refrigerator, causes significant acceleration of the decay process. Once that begins, it is time to say goodbye and throw it out.

These days, bank regulators are also thinking about decay, but not just in terms of the questionable tuna salad in their lunch boxes. This time their worries are focused on deposits and the potential decay that could occur in banks if rates rise and normal funding sources say goodbye.

For its part, the FDIC defines the "decay rate" as an estimate of the amount of existing non-maturity deposits that will run off over the life of the deposit. Why so much focus on decay rates now? In the long period of near zero interest rates, depositors have really not focused on the interest rate paid on deposits. No one spends much time worrying over a 25bp difference in rates and therefore many depositors who traditionally would have looked for more return in time deposits like CDs have simply let those deposits sit in checking or savings accounts. It's just not worth the trouble to lock money up with rates so low. The primary objective of these depositors has been security of FDIC insurance and availability.

Regulators think that these types of depositors might become more rate sensitive with higher deposit rates, which will likely come with higher short term interest rates when the Fed begins policy tightening (broadly expected later this year). It's been a really long time since the Fed tightened rates and no one really knows how quickly depositors will change their behavior, which is why regulators are so worried.

Usually, regulators consider non-maturity deposits to be solid gold, but this time around they worry that deposits that have migrated to non-maturity accounts are likely to move back to time deposits once rates rise.

To better prepare, banks can gather appropriate historical information to determine what proportion of non-maturity deposits they think will become more sensitive and could therefore be considered surge deposits. The FDIC reminds bankers that while historical data on deposit pricing provides a good starting point and some perspective for developing assumptions, banks should consider qualitative adjustments to deposit betas to reflect the possibility that surge deposits will be strongly rate-sensitive once interest rates start increasing.

It is important for banks to understand the quantity of non-maturity deposits that could decay quickly (as customers become more sensitive) and how many in the end will just sit there. This is like understanding that the peach on the kitchen counter will decay much more quickly than the one in the refrigerator - it is all about the environment. Customer behavior is more complex and is determined by many things, but overall a deep, multi-product relationship is far less sensitive than a relationship based on pricing deals (whether on the deposit or the loan side).

Banks should measure and analyze the expected sensitivity or beta factor of non-maturity deposits by the expected magnitude of change in deposit rates compared to a driver rate. Driver rates are those rates that dictate the repricing characteristics of the bank's assets and liabilities like Fed Funds, LIBOR, Treasury yields, prime etc. Given that Fed Funds and prime have been unchanged for 6Ys now, recent history will not be a reasonable guide, so a number of future scenarios should be considered.

In the end, the rate of deposit decay will be correlated to changes in interest rates, but the beta factor will also be dependent upon the relationship your bank has with its customers. Making every effort to deepen those relationships should ultimately slow the effect of the invasive microorganisms of competition.

BANK NEWS

M&A Activity

1) Three bank holding company Southeast Bancshares ($291mm, KS) will acquire The First National Bank of Howard ($8mm, KS) for an undisclosed sum. 2) Five bank holding company Foresight Financial ($921mm, IL) will acquire State Bank of Herscher ($136mm, IL) for an undisclosed sum.

Interesting

USAA said its customers are warming up to technology it has rolled out that allows users to use facial and voice recognition banking authentication. So far, USAA says almost 3% of its members are using the technology.

Corporate Borrowers

Moody's reports the default rate on speculative corporate borrowers declined last year to 2.0% vs. 3.0% in 2013. Moody's projects the default rate will increase to 2.7% in 2015, as rates rise and global economic conditions remain soft, but that is still better than the historical average default rate for these borrowers of 4.5%.

Updated Regulations

The OCC updated its 51 page examiner handbook around deposit related credit, so bankers active in this area should be aware. Specifically, this updated booklet will be used by examiners when they arrive at banks to look at deposit related credit products and services that include check credit (overdraft lines of credit, cash reserve transfers, special checks), overdraft protection (for insufficient funds) or deposit advance products (small-dollar, short-term credit product offered to customers maintaining a deposit account, reloadable prepaid card, or similar deposit-related vehicle at a bank).

Rate Hikes

Fed San Francisco President Williams said in an interview that he thinks "by mid-year it will be the time to have a serious discussion about starting to raise rates."